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No. 82-169

*In The*

# Supreme Court of the United States

*October Term, 1981*

**CENCO INCORPORATED,**
**Petitioner,**

**vs.**

**SEIDMAN & SEIDMAN,**
**Respondent.**

**On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit**

## REPLY BRIEF IN SUPPORT OF PETITION

Dated: September 3, 1982

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## REPLY BRIEF IN SUPPORT OF PETITION

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Respondent Seidman & Seidman does not dispute that the Petition presents important questions. The legal relationship between public-company shareholders and auditors has a vital impact on federal securities law policies.

Nor does Seidman dispute the conflict shown by the Petition (Pet. 11-15) between the Court of Appeals decision and specific provisions of the federal proxy law. Federal law requires annual audits so shareholders can vote intelligently when they elect corporate managers. The Court of Appeals decision, however, allows auditors who wrongfully failed to provide shareholders with truthful reports to assert, as a defense, the shareholders' misinformed choice of dishonest managers that resulted from the auditor's failure. This result inverts the federal policy. Shareholders who are guaranteed truthful audit reports by federal law and by contract should not be deprived of that protection for the benefit of auditors who knowingly suppressed the truth in order to keep large fees.

The error by the Court of Appeals has grave consequences for the administration of the federal securities laws. This

Court should grant certiorari for this reason alone. Supreme Court Rule 17.1(c); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 471 (1977). Seidman ignores that error in its response.

Skirting the fundamental error below, Seidman responds to the Petition with procedural arguments for withholding review. These arguments not only miss the point of the Petition but mistakenly portray the record below.

## I. THE QUESTION OF FEDERAL COMMON LAW IS PROPERLY PRESENTED FROM THE RECORD BELOW.

Respondent asserts that petitioner's question of federal common law "attempts to raise a question *de novo*" and that petitioner "did not argue [the issue] below." (Opp. Br. ii). These contentions are not accurate. The federal common law question was pleaded, argued, and directly addressed by the Court of Appeals.

The Seventh Circuit acknowledged that petitioner's cross-claims against respondent Seidman "alleg[ed] that Seidman was liable to Cenco *under both federal and state common law* for having failed to prevent the fraud by Cenco's managers."[1] (App. A-3). The court noted that Cenco had pleaded federal-question jurisdiction under 28 U.S.C. § 1331 and Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa. But the Seventh Circuit concluded, contrary to holdings of this Court, that "these statutes are not pertinent" because Cenco had not pleaded a "violation of a federal statute or rule." (App. A-4). *See Illinois* v. *City of Milwaukee*, 406 U.S. 91, 99-100 (1972) (§ 1331 supports federal common law jurisdiction).

Petitioner also addressed the federal question in briefs to the Seventh Circuit. In its main brief, petitioner presented securities law decisions that protected public shareholders, as a matter of federal policy, by refusing to impute officers' or directors' fraud to their corporation as a defense to claims of corporate injury.[2] In response, Seidman urged the Seventh Circuit that granting such a defense to auditors would not affect "[t]he rights of innocent parties, such as lenders and

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[1] All emphasis is supplied unless otherwise indicated.

[2] Brief for Appellant Cenco Incorporated, pp. 42-43 (7th Cir., Sept. 28, 1981), citing the same authorities that appear in the Petition, pages 16-17 and are discussed in Part *IV infra*.

shareholders."[3] Petitioner replied, to the contrary, that shareholders' rights under federal law were adversely affected by the rule Seidman urged. In fact, petitioner devoted an entire section of its brief (not "one sentence" as respondent asserts, Opp. Br. 15) to federal securities laws and policy that required GAAS audit reports, protected public shareholders and supported the declaration of a federal rule of law.[4] (*See* App. I hereto).

That the Seventh Circuit devoted little discussion to the federal question (App. A-4) does not change the record showing that petitioner raised the issue.

The Seventh Circuit in fact magnified the federal interest in this suit by grounding its decision, *sua sponte*, on a concept of shareholder regulation under tort law that conflicts directly with the federal proxy law. (*See* Pet. 11-15). Respondent Seidman never urged below that shareholders should be penalized as a "deterrent" from electing dishonest or negligent managers when, in fact, the shareholders lacked audit information they were entitled to have when voting. This was the Seventh Circuit's novel basis for resolving the case.[5]

The Seventh Circuit thereby fashioned a pivotal federal question in deciding whether a corporate client may recover from its auditor. That question is the relative responsibilities of public-company shareholders and auditors—a question directly governed by the federal securities laws. A leading decision on the federal common law, *Ivy Broadcasting Co.* v. *American Tel. & Tel. Co.*, 391 F.2d 486 (2d Cir. 1968),[6] held that a

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[3] Brief of Appellee Seidman & Seidman, p. 45 (7th Cir., Nov. 30, 1981).

[4] Reply Brief of Appellant Cenco Incorporated, pp. 48-49 (7th Cir., Jan. 29, 1982) (App. I).

[5] Seidman always based its case below on the fact that under general agency rules the fraudulent officers *were* their client, Cenco. Petitioner Cenco rejoined that such an application of agency rules conflicted with both state and federal law. *See* Pet. 15-18; and Part IV, *infra*. The Seventh Circuit never confronted the agency precedents adverse to Seidman's defense.

[6] Cited with approval in *Illinois* v. *City of Milwaukee*, 406 U.S. 91, 100 (1972).

"state created" claim may raise a federal question if a disputed aspect of the claim presents a question of federal law:

> "The test we have stated for determining whether a complaint presents a federal question is
>
> > '... whether a properly pleaded "state created" claim itself presents a "pivotal question of federal law," for example because an act of Congress must be construed or "'federal common law' govern[s] some disputed aspect" of the claim."

391 F.2d at 489, quoting *McFaddin Express, Inc.* v. *Adley Corp.*, 346 F.2d 424, 426 (2d Cir. 1965), *cert. denied*, 382 U.S. 1026 (1966). The Ivy Broadcasting decision invoked federal common law to determine negligence and breach of contract claims arising from a contract to provide regulated communications service. Federal statutes had not been violated; federal statutes granted no remedy; and no federal remedy could be inferred from the relevant Act of Congress. Nevertheless, the contract sued upon involved regulated services and questions of federal law:

> "A case may 'arise under' federal law, even though the claim is created by state law, if the complaint discloses a need for the interpretation of an act of Congress. [Citations omitted.] We believe that a cause of action similarly 'arises under' federal law if the dispositive issues stated in the complaint require the application of federal common law, a conclusion which we have intimated in prior decisions."

*Id.* at 492.

The Seventh Circuit's premising its decision on shareholder "deterrence" created a federal common law question beyond that raised by the parties. Even treating petitioner's claims as "state created" claims, the Seventh Circuit erred by refusing to consider federal policy when the court's novel analysis of those claims raised a pivotal question of shareholder rights. *Ivy Broadcasting, supra.*

This Court has declared a paramount federal interest in the rights and remedies of public shareholders in connection with proxy solicitations to elect corporate directors or to vote on other matters reserved to the shareholders. *J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964). Congress believed that "[f]air corporate suffrage is an important right'" and intended to

" 'control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of stockholders.' " 377 U.S. at 431, *quoting* H.R. Rep. No. 1383, 73d Cong., 2d Sess., at 13-14. Congress had "broad remedial purposes." 377 U.S. at 431-32. Therefore, the Court concluded, "it is the duty of the [federal] courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." *Id.* at 433.

The Court of Appeals decision *sua sponte* entered the federal realm of shareholder voting rights (including shareholders' right to truthful audit reports under SEC Rule 14a-3 and Regulation S-X) without considering federal law and policy. By this initiative, the court created a direct conflict with federal law. The Seventh Circuit thus accentuated the question of federal common law raised on the pleadings and briefs below.

Petitioner's question of federal common law is properly presented to this Court.

## II. THE PETITION PRESENTS A PROPER QUESTION OF AUDITOR LIABILITY ON THE RECORD BELOW.

Petitioner's question of auditor liability arises from facts that the Court of Appeals conceded the jury *could have found* on the trial evidence. These facts properly frame the legal question for review. The Petition challenges instructions that precluded the jury from reaching verdicts of liability favorable to petitioner regardless of what facts petitioner proved.

Respondent dodges the point when it argues that petitioner "assume[s] facts" because there was "no finding by either court or jury that respondent knowingly concealed, or even had, a suspicion of petitioner's fraud." (Opp. Br. i). The Seventh Circuit found sufficient trial evidence that Seidman suspected the fraud, knowingly concealed its suspicions and issued false audit reports. The court stated: "Cenco's evidence tended to show that . . . Seidman's auditors became suspicious [of the fraud] . . . concealed their suspicions and kept giving Cenco a clean bill of health in their audit reports; . . ." (App. A-3). The court added that Seidman "was (*or so the jury could have found*) an intentional tortfeasor." (App. A-11).

The trial record supports the factual premises of the Petition. Respondent Seidman uses circular reasoning to finesse

the legal question thus presented: because there was a general liability verdict based on jury instructions that precluded judgment against respondent, respondent urges there are no fact findings of its wrongdoing to support petitioner's challenge to the instructional error. Respondent's argument goes too far because the result would be to insulate every general jury verdict from review of legal errors in the instructions.

## III. RESPONDENT'S VERSION OF THE JURY INSTRUCTIONS CONTRADICTS BOTH THE RECORD AND ITS OWN PREVIOUS POSITION.

The jury instructions automatically imputed an officer's fraud to Cenco and automatically excused the auditor from liability if such fraud existed. At trial, respondent Seidman vigorously argued this consequence of the instructions. Now, before this Court, Seidman takes the contrary position that (1) "the [agency] instruction given was significantly more restrictive than Cenco's characterization" and that (2) Seidman was not " 'excused' from responsibility for its audits by the District Court's instructions." (Opp. Br. 8).

However, what respondent Seidman told the jury the instructions said is exactly what petitioner Cenco here contends the instructions said.[7] On agency, respondent stated in closing argument that the instructions dictated "that the acts of management, acts of officers and directors, *are* the acts of the Company." (Vol. 26, Tr. 5653 App. J-1). On the auditor's excuse, respondent told the jury that fraud by corporate officers excused the auditor "*no matter what Seidman did.*" (Vol. 26, Tr. 5647; App. J-1). "Assume Seidman did all that and *assume Seidman lied about it. It doesn't make any difference,* Cenco [by its officers] knew it, and the law is going to be enunciated to you, ladies and gentlemen, *they have no claim—easy.*" (Vol. 26, p. 5727; App. J-3).[8]

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[7] Respondent's jury arguments are highly relevant. Courts review error in jury instructions "in the light, not only of the instructions as a whole, but of the . . . closing arguments. . . . We consider all that the jury heard." *Alloy International Co.* v. *Hoover-NSK Bearing Co.*, 635 F.2d 1222, 1226 (7th Cir. 1980).

[8] Excerpts from Seidman's Closing Argument (App. J hereto).

The instructions themselves unequivocally presented the issue for review. The District Court instructed that "agents of a corporation *are* the officers and employees." (App. D-5). The court instructed the jury that "if you find that Cenco, through the conduct or acts of its officers and employees, was a participant in the fraud, you *must find Seidman not liable.*" (App. D-16). The force of these erroneous instructions makes irrelevant respondent's urgings that some correct instructions were given: "[E]rroneous instructions are not cured by correct instructions in other portions of the main charge because the jury may be misled." *Seltzer* v. *Chesley*, 512 F.2d 1030, 1035 (9th Cir. 1975).

Respondent wrapped itself in the instructions when it stood before the jury, arguing that the instructions permitted no liability based on the auditor's omissions or even lies. Respondent now wraps itself in the jury's general verdict, giving a different version of the instructions. The importance of review in this case should not be frustrated by efforts to avoid the issue.[9]

## IV. RESPONDENT'S ATTEMPT TO DISTINGUISH PETITIONER'S SECURITIES LAW CASES IGNORES THEIR HOLDINGS ON PROTECTION OF INVESTORS.

The Second Circuit stated in *Goldberg* v. *Meridor* 567 F.2d 209, 215 (2nd Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978), that talismanic agency-imputation defenses like respondent Seidman's must bow to larger objectives of the law:

> " 'When it is practical as well as just to do so, courts have experienced no difficulty in rejecting such cliches as the directors constitute the corporation and a corporation . . . cannot defraud itself.' "

567 F.2d at 215. Noting that the federal securities policy is a larger objective which takes precedence, the court warned:

> " 'There can be no more effective way to emasculate the policies of the federal securities laws than to deny relief [to the corporation] solely because a fraud was committed by a director rather than by an outsider.' " *Id.*

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[9] Seidman makes other excuses to preserve bad law including changes in Cenco stock ownership since trial. Seidman also claims that all "the shareholders who claimed they were injured by the fraud recovered." (Op. Br. ftn. 10). However, only those shareholders who bought or sold Cenco stock during a fixed time period were allowed to join the class.

*Accord, Shell* v. *Hensley, Supra,* 430 F.2d at 826-27. The Seventh Circuit ignored this warning.

Federal securities law precedents (Pet. 16-17) conflict directly with the Seventh Circuit decision. Those precedents[10] hold that application of agency-imputation fictions will not be allowed to frustrate federal securities policy protecting shareholders. Specifically, those precedents require that: (1) where shareholders[11] have a right to information under the federal securities laws, and (2) they are deceived or denied that information, then (3) a corporate cause of action may not be defeated by imputing to the corporation a dishonest officer's knowledge of the information wrongfully withheld.

The Seventh Circuit's decision is in direct conflict. Petitioner's shareholders were entitled under federal proxy laws to truthful audit reports so they could elect honest and competent management. The shareholders (and the majority of petitioner's directors) were deceived by respondent's untruthful audit reports. As a result, the shareholders unwittingly allowed dishonest managers to continue in office. Ignoring the securities law precedents, the Seventh Circuit imputed to petitioner the knowledge of its dishonest officers in order to defeat the corporate cause of action. Ironically, the Court of Appeals did so on the express basis that shareholders should be penalized for their misinformed choice in corporate elections, even though their misinformed choice stemmed from their auditor's wrongdoing.

None of respondent's attempts to distinguish the federal securities law precedents face their holdings.

*First,* respondent points out the absence of specific holdings on auditors' liability. (Opp. Br. 9-11). But nothing unique

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[10] *IIT, An International Invest. Trust* v. *Cornfeld,* 619 F.2d 909 (2d Cir. 1980); *Alabama Farm Bureau Mutual Casualty Co.* v. *American Fidelity Life Ins. Co.,* 606 F.2d 602 (5th Cir. 1979), *cert. denied* 449 U.S. 820 (1980); *Maldonado* v. *Flynn,* 597 F.2d 789 (2d Cir. 1979); *Goldberg* v. *Meridor,* 567 F.2d 209 (2d Cir. 1977), *cert. denied* 434 U.S. 1069 (1978); *Shell* v. *Hensley,* 430 F.2d 819 (5th Cir. 1970); *Schoenbaum* v. *Firstbrook,* 405 F.2d 200, *vacated* 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied* 395 U.S. 906 (1969).

[11] Or innocent or disinterested directors.

about auditors either controlled the decision below or distinguishes the securities law precedents.[12]

*Second,* respondent asserts that five of the cited decisions were derivative claims and therefore involved "innocent parties." (Opp. Br. 11-12). This is a difference, not a distinction. Derivative suits, by definition, pursue the corporation's cause of action as does petitioner. They are subject to whatever defenses can be asserted against the corporation (otherwise the question of agency-imputation defenses would not even arise). *See Shell* v. *Hensley, supra,* at 826; 13 Fletcher, *Cyc. Corp.* (Perm. Ed.) at 391.

*Third,* respondent misses the point in suggesting that the decisions can be distinguished because "Rule 10b-5 is not involved herein." (Opp. Br. 12). The holdings of the cited federal securities decisions turn, in every instance, on the existence of a federally-protected right that shareholders be informed so that they can act as *they* judge best for the corporation. No distinction arises between this case and the cited precedent either because of the source of the shareholders' right to an informed vote; (Rule 10b-5; Rule 14a-9; or as here, Rule 14a-3). *Maldonado* v. *Flynn, supra,* for example, arose under both Rule 10b-5 and Rule 14a-9 regarding proxy solicitation. The court addressed the very question raised by the Seventh Circuit, which is the regulation of shareholder rights in corporate elections:

> "Here, . . . the alleged . . . non-disclosures involve matters of direct and deep concern to shareholders in the exercise of their right to vote, which the Exchange Act expects to be fully disclosed in proxy solicitations for election of officers and directors. . . ."

597 F.2d at 796.

*Fourth,* respondent urges a distinction that petitioner's officers intended to benefit the corporation, not to loot it. (Opp. Br. 12). "Benefit," however, is in the eyes of the beholder. The federal securities laws guarantee the right of shareholders to make their own judgments of the corporation's best interests with full possession of material informa-

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[12]The Second Circuit, for example, made no distinction among the accounting firm defendant, the investment firm defendant, and corporate insider defendants when it repudiated agency-imputation defenses against the corporation in *Goldberg* v. *Meridor, supra.*

tion. This right cannot rationally depend on corrupt officers' subjective judgment as to what is of benefit to the corporation. Rather, as this Court has held, shareholders have an "objective" right to material information "to enable *the shareholders* to make an informed choice." *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 444-45, 448 (1976); *see also Alabama Farm Bureau Mutual Casualty Co.* v. *American Fidelity Life Ins. Co., supra*, at 614 (where a similar fact situation was found to be material).

Excusing auditors who could be found to have intentionally deprived shareholders of information regarding the integrity and competency of their management challenges important federal policies.

## CONCLUSION

A circuit court decision sanctioning intentional frustration of federally protected voting rights certainly presents a federal issue. The nature of the issue mandates a uniform predictable national rule.

Review should not be side-tracked or delayed. The extreme fact situation described by the Seventh Circuit provides an unusually appropriate vehicle for resolution of the question.

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# APPENDICES

**APPENDIX I**

## REPLY BRIEF OF APPELLANT CENCO INCORPORATED (7th Circuit, January 29, 1982)

### D. The Rule Seidman Proposes Would Work Against Public Policy by Creating a Gap in the Legal Protection for Investors and Lenders.

Seidman asserts that the rule it presses would leave "[t]he rights of innocent parties, such as lenders and shareholders ... unaffected." (Seid. Br. 45). To the contrary, Seidman's rule would prejudice the interests of innocent persons whose protection is a paramount goal of federal law.

First, the federal securities laws required Cenco, like any public company, to publish financial statements audited by independent certified public accountants according to GAAS. (Cenco Br. 3). Federal law required Cenco to hire auditors to conduct GAAS audits if Cenco wanted to participate in the national securities markets. The integrity of the securities markets upon which investors rely thus hinges, in part, on the auditor's promise to his public-company client that he will apply GAAS.

Second, Seidman's rule would preclude recovery by the client corporation for damage to its property caused by the auditor's wrongful performance. Shareholders and lenders have a stake in the corporation and are injured when it sustains a loss. They have no direct cause of action against the auditor for the real but indirect loss when the corporation is damaged. They may only sue the auditor, if at all (see below), based on transactions in which they individually relied on wrongfully certified financial statements, such as overpayment for the company's securities or other trading losses. Shareholders and lenders otherwise share in the corporation's loss of a collective property. These victims

must look to the corporation's right of action against the auditor as a way to be made whole.*

Third, the result of Seidman's rule is that no one could hold the auditor liable for *negligence* permitting major frauds and misrepresentations in management's financial statements—the types of fraud most harmful to investors and lenders. As the law presently stands, even shareholders and lenders who have sustained transaction losses can, except in limited cases, only hold the auditor liable for recklessness or fraud in his audit. *Cf. Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

Thus, while both federal law and contract require careful GAAS audits, under Seidman's rule no one could hold the negligent auditor accountable when he fails to provide that the company, its shareholders, and its lenders need most: protection from false financial statements. This court should declare a federal rule which protects the interests of all who depend on the auditor's contract. *Cf. Illinois* v. *City of Milwaukee*, 406 U.S. 91, 101-08 (1972).

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*Thus, Seidman is incorrect in suggesting that all injured Cenco shareholders "sued separately as a class" and recovered for their losses. (Seid. Br. 38). The shareholder class was limited to those who sustained actual trading losses within a fixed time period. Cenco shareholders who did not buy or sell within that period have recovered nothing for the damage caused by the fraud to the value of their investment. These shareholders' interests are represented by the present action brought in Cenco's corporate capacity.

## APPENDIX J

### WEISBARD—CLOSING ARGUMENT

5647

No matter what Seidman did or didn't do, one thing is inescapable, that Cenco was the cause of its own injury, and the only witness they are willing to put on that had anything to do with the company, Mr. Case, testified that nothing in or out of Seidman's work papers excuses Cenco's fraud.

• • •

5653

Well, if it's a red herring or a smoke screen, the Court is going to instruct you on a red herring and a smoke screen, because he is going to tell you that acts of management, acts of officers and directors, are acts of the company, and whether the company lied is very relevant, relevant on the issue of deceiving Seidman, relevant on credibility, relevant on whether the company could have prevented any injury which it's now looking to collect from Seidman as a scapegoat.

• • •

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An innocent party may rely on an auditor, because he doesn't know anything about what's going on. But a company knows its books and records, it knows its transactions, it knows all and more than the auditor knows.

• • •

5721

You might as well dispel from your minds any notion that Cenco was hurt because Seidman didn't follow GAAS, because if Seidman didn't, let's say, and hadn't done it, what would have happened? They simply would have told Cenco

what it already knew, it committed the fraud. It would have been no surprise.

• • •

5725

So now summing up on negligence, based on the instructions on the law you are going to get, ladies and gentlemen, and which you are going to apply to the evidence, there are two independent reasons, each enough to return a verdict against Cenco in favor of Seidman on the negligence claims, one is that Cenco was guilty of both contributory negligence and fraud, and either one of them would be enough to bar the claim and, second, as we said in the breach of contract discussion, there is no way Cenco can show that the injury it claims it suffered was not caused at least in part by Cenco.

• • •

5726-5728

But I suppose that counsel for Cenco will allege that Seidman audits were so poor that they—but they were so smart that they should have known that their poor audits didn't conform to GAAS. We don't have to labor that point. You have the evidence before you, but it makes no difference on the fraud count, because, once again, there are unavoidable tests which Cenco must meet to obtain a verdict on fraud. For one thing, you will be instructed that even if Seidman made a statement of fact and it was untrue, and they knew it, which we deny, but let's say all that happened, they have to show that Cenco had a right to rely on Seidman's statements. Now, that is a laugh. How could they have a right to rely on statements when they knew that the statements were wrong?

And you are going to be told in an instruction from the Court, in effect, that a party cannot claim to have relied on a statement which it knew to be false.

Well, if you carry out that instruction, ladies and gentlemen, Cenco's fraud claim is out the window. There is no way they can show that they had a right to rely on Seidman's statements, taken at what they say it was, Seidman saying, "Yes, we have looked at Cenco's financial statements for '74, we believe they are all correct, truthful." Assume Seidman did all that and assume Seidman lied about it. It doesn't make any difference, Cenco knew it, and the law is going to be enunciated to you, ladies and gentlemen, they have no claim—easy. They had no right to rely, because the party with knowledge has no right to rely.

And you are going to be told also why Cenco has knowledge. Cenco has knowledge because Read, Strelsin, Magdovitz, Spiegel, Rabjohns all had knowledge. That is the knowledge of the company.

• • •

## CERTIFICATE OF SERVICE

Donald E. Scott, a member of the Bar of this Court and one of the counsel of record for petitioner, Cenco Incorporated, certifies that five (5) copies of the foregoing "Reply Brief in Support of Petition" were served by hand upon counsel of record for Seidman & Seidman, Samuel Weisbard, Esq., McDermott, Will & Emery, 111 West Monroe Street, Chicago, Illinois 60603, this 3rd day of September, 1982. All parties required to be served have thus been served.

DONALD E. SCOTT